



## **CRS Report for Congress**

# **The U.S. Financial Crisis: Lessons From Japan**

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### **Summary**

Japan's five bank bailout packages in the late 1990s may hold some lessons for the United States. Most of the packages were administered by the Deposit Insurance Corporation of Japan (DICJ). The packages had an announced value of \$495 billion. The DICJ reports that it provided \$399 billion to Japan's troubled financial institutions of which it has recovered \$195 billion. Overcoming the crisis in Japan's banks took a combination of capital injections, new laws and regulations, stronger oversight, a reorganization of the banking sector, moderate economic recovery, and several years of banks working off their non-performing loans. This report will be updated as circumstances warrant.

When the U.S. Treasury planned the \$700 billion bailout package (Emergency Economic Stabilization Act of 2008, H.R. 3997) to address the U.S. financial crisis, it reportedly examined the experience of Japan as it grappled with its banking crisis in the 1990s.<sup>1</sup> This report reviews the major actions by the Japanese government in dealing with its crisis and highlights some of the lessons learned from their experience.

Like the current U.S. financial crisis, Japan's began with stock market and real estate bubbles. During the latter half of the 1980s, Japan's monetary authorities flooded the market with liquidity (money) in order to enable businesses to cope with the rising value of the yen. Businesses did invest in new capital equipment to become more competitive in international markets, but the excess liquidity also found its way into speculation in Japan's stock market, in real estate ventures, and in foreign investments. At that time, the market value of both land and equities was rising so fast that investors and speculators could hardly miss. Investors tended to ignore risks. The larger mistake for them was not to borrow and invest and consequently not be positioned to reap the returns from rising

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<sup>1</sup> Faiola, Anthony and David Cho. "Alternative Solutions Diverge From Administration's Approach," *The Washington Post*, September 24, 2008. p. A.1.

| Report Documentation Page  |                                    |                                     |   | Form Approved<br>OMB No. 0704-0188                  |                                 |
|--|------------------------------------|-------------------------------------|---|---|---------------------------------|
| Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number. |                                    |                                     |   |   |                                 |
| 1. REPORT DATE<br><b>29 SEP 2008</b>   |                                    | 2. REPORT TYPE                      |   | 3. DATES COVERED<br><b>00-00-2008 to 00-00-2008</b> |                                 |
| 4. TITLE AND SUBTITLE<br><b>The U.S. Financial Crisis: Lessons From Japan</b>  |                                    |                                     |   | 5a. CONTRACT NUMBER                                 |                                 |
|  |                                    |                                     |   | 5b. GRANT NUMBER                                    |                                 |
|  |                                    |                                     |   | 5c. PROGRAM ELEMENT NUMBER                          |                                 |
| 6. AUTHOR(S)   |                                    |                                     |   | 5d. PROJECT NUMBER                                  |                                 |
|  |                                    |                                     |   | 5e. TASK NUMBER                                     |                                 |
|  |                                    |                                     |   | 5f. WORK UNIT NUMBER                                |                                 |
| 7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)<br><b>Congressional Research Service, Library of Congress, 101 Independence Ave, SE, Washington, DC, 20540-7500</b>   |                                    |                                     |   | 8. PERFORMING ORGANIZATION REPORT NUMBER            |                                 |
| 9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)  |                                    |                                     |   | 10. SPONSOR/MONITOR'S ACRONYM(S)                    |                                 |
|  |                                    |                                     |   | 11. SPONSOR/MONITOR'S REPORT NUMBER(S)              |                                 |
| 12. DISTRIBUTION/AVAILABILITY STATEMENT<br><b>Approved for public release; distribution unlimited</b>  |                                    |                                     |   |   |                                 |
| 13. SUPPLEMENTARY NOTES  |                                    |                                     |   |   |                                 |
| 14. ABSTRACT   |                                    |                                     |   |   |                                 |
| 15. SUBJECT TERMS  |                                    |                                     |   |   |                                 |
| 16. SECURITY CLASSIFICATION OF:  |                                    |                                     | 17. LIMITATION OF ABSTRACT<br><b>Same as Report (SAR)</b> | 18. NUMBER OF PAGES<br><b>6</b>                     | 19a. NAME OF RESPONSIBLE PERSON |
| a. REPORT<br><b>unclassified</b>   | b. ABSTRACT<br><b>unclassified</b> | c. THIS PAGE<br><b>unclassified</b> |   |   |                                 |

markets. Banks considered most loans with real estate as collateral as being unquestionably secure. Then the bubbles burst.

Japan's Nikkei stock market average peaked in 1989 at 40,000 and dropped by 50% in one year and more than two-thirds to about 12,000 by August 2001. Japan's banks are allowed to hold equities as part of their capital base. The value of the unrealized capital gains on such stock holdings dropped from \$355 billion in 1989 to \$42 billion in 2001. This drastically reduced key capital reserves for many banks. Also, by 2000, commercial land values in the six major metropolitan areas had fallen by 80% from their peak level in 1991. Residential and industrial land values also had fallen by nearly 20%.<sup>2</sup>

The bursting of this economic bubble caused the value of collateral underlying many bank loans to drop below the value of their loan principal. Also, commercial real estate ventures, especially office buildings, became unprofitable as rents fell. As the economy slowed, companies also faced excess capacity, excess inventories, and lower profits. Also as more and more loans turned sour, more and more of the underlying real estate had to be sold at "bargain" prices. In 1995, Japan's banks reported \$280 billion in non-performing loans,<sup>3</sup> but this figure turned out to be vastly understated.<sup>4</sup> Japanese financial institutions at this time, however, generally did bundle and repackage these loans as collateralized debt obligations or rely extensively on derivatives or other financial instruments. Mortgage defaults tended to be on commercial property, not on private residences.

At first, the Japanese government's strategy was forbearance, a strengthening of deposit protection, provision of emergency liquidity, and some assistance to encourage mergers of failed institutions. The crisis worsened in 1995-1996 following the bankruptcy of several specialized housing loan companies (*jusen*). In 1996, the government made its first injection of capital to purchase assets from ailing housing lenders. This bailout proved to be quite unpopular politically and may have contributed to tentativeness later on the part of government as the downward spiral quickened.

By 1997, Japan's banking sector was in a full systemic crisis. The government responded by making \$250 billion (¥30 trillion) available of which \$108 billion (¥13 trillion) went to banks and \$142 billion (¥17 trillion) to the Deposit Insurance Corporation of Japan. In 1998, the government bought the bankrupt Long-Term Credit Bank<sup>5</sup> and Nippon Credit Bank. These two banks had no consumer deposit system but borrowed funds on financial markets to lend on a long-term basis to businesses. These banks were eventually sold to private investors. The government also took over the management of many financial institutions.

In March 1998, the government injected another \$14 billion (¥1.8 trillion) to bolster bank balance sheets and in March 1999 injected another \$62.5 billion (¥7.5 trillion). By

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<sup>2</sup> Bank of Japan. *Financial and Economic Statistics Monthly*, various issues.

<sup>3</sup> Japan. Financial Services Agency.

<sup>4</sup> For details, see CRS Report RS20994, *Japan's Banking "Crisis,"* by Dick K. Nanto.

<sup>5</sup> Later bought by the New York-based Ripplewood Holdings and other investors.

October 1998, the government had invested \$495 billion (¥60 trillion yen), or 12% of gross domestic product, for the financial support of banks.<sup>6</sup>

For much of the 1990s, however, the hope of the government was that if it could keep banks operating, their profits from operations and capital gains from equity holdings could fund the writeoffs of bad loans. The Bank of Japan kept its interest rate for banks low so that they could increase profits from new lending. Between 1995 and 2003, Japan's banks wrote off a cumulative total of \$318 billion (¥37.2 trillion) in non-performing loans, but new ones appeared so fast that the total outstanding amount kept increasing and peaked in March 2002 at \$330 billion (¥43.2 trillion) or 8.4% of total lending.<sup>7</sup>

Through a combination of capital injections, new laws and regulations, stronger oversight, a reorganization of the banking sector,<sup>8</sup> moderate economic recovery, and several years of banks working off their non-performing loans, the Japanese banking sector now has recovered. By September 2005, the banks reported 3.5% of their total lending as non-performing, a tolerable amount. By 2008, Japanese banks and brokerage houses had become strong enough that Nomura Holdings had agreed to buy the Europe and Middle East operations of Lehman Brothers as well as Lehman's franchise in Japan and Australia. Mitsubishi UFJ Financial Group has agreed to buy 20% of Morgan Stanley.<sup>9</sup>

## Net Cost of Bailouts

The various bailout packages in Japan were administered primarily by the Deposit Insurance Corporation of Japan (DICJ). When a financial institution fails, the DICJ may extend assistance to another financial institution that purchases assets or merges with the failed financial institution in order to facilitate the transaction. The DICJ also works to prevent financial institutions from failing. The forms of assistance include a direct money grant, a loan or deposit of funds, purchase of assets, a guarantee or assumption of debts, a subscription of preferred stock, and loss sharing. Not all of the activities of the DICJ, however, are related to the bailout packages. It also has ongoing operations associated with its traditional function of insuring bank deposits. The annual reports of the DICJ, however, provide detail on the disposition of \$399 billion of the \$495 billion in funds announced in Japan's financial assistance packages.

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<sup>6</sup> For the United States, 12% of GDP in 2008 dollars is about \$1.7 trillion.

<sup>7</sup> Japan. Financial Services Agency. Quoted in Organization for Economic Cooperation and Development, *OECD Economic Surveys, Japan (Paris, OECD Publishing) Vol. 2006/13, July 2006*, p. 53.

<sup>8</sup> The Industrial Bank of Japan, Daiichi Kangyo, Fuji, and Yasuda Trust Banks merged to form the Mizuho Financial Group (2003). The Bank of Tokyo-Mitsubishi, Mitsubishi Trust Bank, and Nippon Trust Bank merged to form the Mitsubishi Tokyo Financial Group (2001). Sumitomo Bank and Sakura Bank merged to form the Sumitomo Mitsui Financial Group (2002). Sanwa Bank, Tokai Bank, and Toyo Trust & Banking merged to form UFJ Holdings (2001). Asahi Bank merged with Daiwa Bank to form Resona Holdings (2001).

<sup>9</sup> "Bailout Faces Delays as Goldman Gets Boost." *Reuters*, September 23, 2008.

As shown in **Table 1**, as of March 2007, the DICJ had provided financial assistance in the amount of \$399 billion. This included 180 cases with grants of \$159 billion, asset purchases of \$83 billion, capital injections of \$106 billion, and other assistance (mostly loans) of \$51 billion.

The grants were funded by \$110 billion (¥13 trillion) in DICJ bonds issued (repaid from taxpayer funds) and from premiums from deposit insurance. Of the asset purchases of \$83 billion, the DICJ recovered \$79 billion. The asset purchases included \$54 billion in assets from failed financial institutions (of which \$60 billion had been recovered) and \$25 billion in shares purchased (of which \$14 billion had been recovered).

**Table 1. The Deposit Insurance Corporation of Japan's Assistance to Financial Institutions and Funds Recovered as of March 2007**

| Type  | Amount Provided                   | Amount Recovered                |
|---|-----------------------------------|---------------------------------|
| 1. Grants   | \$159 billion<br>(¥18.6 trillion) | None                            |
| 2. Purchase of Assets                                 | \$83 billion<br>(¥9.8 trillion)   | \$79 billion<br>(¥9.3 trillion) |
| Of which:   |                                   |                                 |
| Purchase of assets from failed institutions           | \$54 billion<br>(¥6.3 trillion)   | \$60 billion<br>(¥7.0 trillion) |
| Purchase of shares from banks under public management | \$25 billion<br>(¥2.9 trillion)   | \$14 billion<br>(¥1.6 trillion) |
| 3. Capital Injections Under Five Bailout Packages     | \$106 billion<br>(¥12.4 trillion) | \$75 billion<br>(¥8.7 trillion) |
| 4. Other  | \$51 billion<br>(¥6.0 trillion)   | \$41 billion<br>(¥4.8 trillion) |
| Of which:   |                                   |                                 |
| Loans   | \$36 billion<br>(¥4.2 trillion)   | \$36 billion<br>(¥4.2 trillion) |
| Total   | \$399 billion                     | \$195 billion                   |

**Source:** Deposit Insurance Corporation of Japan, *Annual Report 2006*, p. 70.

**Note:** All values converted at the March 2007 exchange rate of 116.26 yen per dollar.

Capital injections included purchases of preferred/common stock and subordinated bonds and the extending of subordinated loans.

Capital injections of \$106 billion came under five different bailout packages and included subscriptions to preferred or common stock, purchases of subordinated bonds, and the extending of subordinated loans. The DICJ had injected capital into 25 different banks. As of March 2007, \$31.3 billion of these assets was still held by the DICJ in the form of preferred shares, common shares, and subordinated loans.

The \$51 billion in the “Other” category included loans to banks which were under special public management, taking delivery of assets under warranty for latent defects,

compensation for losses, lending to assuming financial institutions, and debt assumption. The last capital injection reported by the DICJ was in March 2003.<sup>10</sup>

The Resolution and Collection Corporation (RCC), a subsidiary of the DICJ, borrows funds from the DICJ to purchase and dispose of assets (within three years) from sound financial institutions and some under special public management. As of March 2007, the RCC had purchased assets with claims of \$34.5 billion (¥4.0 trillion) for a discounted price of \$3.0 billion (¥355.7 billion). These assets had been sold for \$5.2 billion (¥609.4 billion) for a gain of 172% for the RCC. In essence, the RCC paid about 9 cents on a dollar for the troubled assets and was able to dispose of them at a profit. The DICJ consults with the Purchase Price Examination Board (an advisory body to the DICJ) with respect to the price it pays for assets. The RCC made no purchases in FY2006 (ending in March 2007).<sup>11</sup>

## Lessons Learned

The following are various lessons and observations that observers have gleaned from the Japanese experience.

- Authorities underestimated the nature and seriousness of the banking problem at first. Most thought the financial problems would resolve themselves through economic growth and by keeping central bank interest rates low in order to increase bank margins and profitability.
- There was a slow recognition of the extent of non-performing loans and the carrying of “zombie” firms that technically were bankrupt but were kept alive by banks. This delayed resolution of the problem.
- Transparency and an updating of definitions and reporting requirements with respect to non-performing loans was important in realizing the true extent of the problems. Many of the rescues of ailing financial firms by a healthier financial institution required a government injection of capital in some form.
- There appeared to be a lack of domestic or external constraints and of political leadership that would have urged authorities to take more decisive action earlier.<sup>12</sup>
- The government began by creating new institutions to handle emergency financial assistance but later transferred such activities to the Deposit Insurance Corporation of Japan (DICJ), an institution that already was working with troubled financial institutions. The DICJ also was given

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<sup>10</sup> Deposit Insurance Corporation of Japan. *Annual Report 2006*, p. 19, 91. Note: 65% of the outstanding balance of shares was in the Resona Bank. In 2006, the DICJ received \$132 million in dividends from these Resona Bank shares but paid \$57 million in interest on its bonds floated to finance the purchase of the shares.

<sup>11</sup> Ibid., p. 22, 70, 84.

<sup>12</sup> Kawai, Masahiro. “Reform of the Japanese Banking System.” *International Economics and Economic Policy*. Heidelberg: Dec 2005. Vol. 2, Issue 4; p. 307ff.

permanent authority to assist ailing financial institutions when so ordered by the Prime Minister.

- The Japanese government injected capital into financial institutions in several ways depending on the situation. In most cases, the DICJ could use its discretion in determining the nature of the assistance.
- Troubled assets were bought at a steep discount from their face value from sound financial institutions (to inject capital) and disposed of without unduly disturbing markets — usually within three years. The two banks that were nationalized were later sold to private investors. Capital injections also took the form of subscriptions to stock, grants, and subordinated loans.
- Even with the \$495 billion financial bailout packages, between 1998 and 2003, Japan's banks wrote off some \$318 billion in non-performing loans. The burden was shared.
- Government holdings of corporate shares have generated dividend income and capital gains for the DICJ.
- Since there are fewer banks in Japan, the authorities could focus recovery efforts on several large banks and fewer than 200 smaller financial institutions (there are about 8,500 banks in the United States) which facilitated information gathering and coordination.
- When Japan announced an early financial bailout package, it placed stringent conditions on the assistance that banks were unwilling to accept. The net result was that the banks ignored the package and tried to bolster their balance sheets by not lending. This was seen as worsening the economic conditions for the country.<sup>13</sup> Most of the assistance to failing institutions, however, carried conditions that were enforced by the DICJ.
- New technologies, globalization, and the blurring of boundaries between types of financial products and institutions made risk management increasingly difficult for financial regulators.<sup>14</sup>
- The bursting of the real estate bubble in Japan caused more difficulty for banks than the bursting of the bubble in stocks because the decline in real estate values effected the value of collateral on much bank lending.<sup>15</sup>
- Japan is considered to have acted too slowly with respect to monetary policy, fiscal policy, and the resolution of problems in the banking sector. Once the economy began to recover, fiscal policy is thought to have tightened too soon.<sup>16</sup>

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<sup>13</sup> Slater, Dan. "Economist Draws Parallels Between U.S., Japan Banking Crises," *Business Week*, March 31, 2008. Internet edition.

<sup>14</sup> Nagano, Satoshi. "Lessons Learnt from the mounting Non-performing Loans in Japan after the 1990s," *Journal of Financial Services Marketing*, Vol. 11, 2, pp. 180-89.

<sup>15</sup> Browne, Lynn Elaine. "Does Japan Offer Any Lessons for the United States?" *New England Economic Review*, 2001, 3, p. 3.

<sup>16</sup> Ibid.